

#2571

signed 2-25-02

**IN THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF KANSAS**

In Re:

**GLENN F. SCHMIDT,
DEBTOR.**

**JAMES A. HANNON,
GLORIA J. HANNON,
PLAINTIFFS,**

v.

**GLENN F. SCHMIDT,
DEFENDANT.**

**CASE NO. 00-41451-7
CHAPTER 7**

ADV. NO. 00-7109

ORDER DENYING SUMMARY JUDGMENT

This proceeding is before the Court on the defendant-debtor's motion for summary judgment. The debtor appears by counsel Harold T. Pickler and Craig Kennedy of Johnson, Kennedy, Dahl & Willis of Wichita, Kansas. The plaintiffs appear by counsel Monte L. Miller of Miller & Larson, Chartered, of Emporia, Kansas. The Court has reviewed the relevant materials and is now ready to rule.

FACTS

Only the following facts are necessary to the Court's ruling. The Court notes that the plaintiffs alleged that certain factual disputes exist, but failed to support those allegations with affidavits or references to other evidence shown to be admissible. Nevertheless, the facts on which the Court is basing this ruling are not contested.

The parties' dispute began after the plaintiffs hired the debtor to build a house. Some work was done on the house, and then disagreements arose. The debtor stopped work and the plaintiffs stopped paying. At this point, the parties agreed to participate in non-binding arbitration. The debtor then had some materials delivered to the house, but it is unclear whether construction work resumed. The debtor filed a mechanic's lien statement for charges for labor and materials allegedly owed but not paid by the plaintiffs. Some months later, the plaintiffs sued the debtor in Kansas state court for breach of contract and fraud. More than a year later, the parties reached a settlement that called for the plaintiffs to make a payment and for the debtor to resume construction under the supervision of a third party, with any future disputes to be resolved by that party through binding arbitration. The debtor returned to work, but a new dispute arose and he abandoned the job. The plaintiffs did not make the payment called for in the settlement. Instead, they moved to reinstate the state court lawsuit.

The state court sent the parties to arbitration. The arbitrator issued a report determining the cost to complete the work that remained to be done on the house was \$31,500, but declining to fix an amount for damages resulting from "defects that can't be repaired."

Some months later, the debtor filed a chapter 7 bankruptcy petition. On his schedules, the debtor listed an unsecured debt to the plaintiffs for \$31,500, marking it as contingent, unliquidated, and disputed. The plaintiffs filed a proof of claim for \$91,000. They also filed a complaint objecting to the discharge of the debtor's obligation to them on the ground that he had made misrepresentations to them in violation of 11 U.S.C.A. §523(a)(2). The debtor has now moved for summary judgment, and the plaintiffs oppose such relief.

DISCUSSION AND CONCLUSIONS

The plaintiffs seek to except the debtor's obligation to them from discharge pursuant to §523(a)(2), which reads in pertinent part:

(a) A discharge under section 727 . . . does not discharge an individual debtor from any debt—

. . . .

(2) for money, property, services, or an extension, renewal, or refinancing of credit, to the extent obtained by—

(A) false pretenses, a false representation, or actual fraud, other than a statement respecting the debtor's or an insider's financial condition.

Although the plaintiffs' complaint does not specify that they are proceeding under subsection (A) of §523(a)(2), nothing in their complaint refers to any statement respecting anyone's financial condition, so it is clear they are not asserting a claim under subsection (B), which concerns only such statements. Instead, they claim that the debtor's obligation to them was incurred through false representations, allegations that concern only subsection (A). While Kansas law may, as the debtor asserts, require a party seeking to establish a claim for damages to prove fraud by clear and convincing evidence, an established debt can be excepted from discharge under §523(a)(2) under a preponderance of the evidence standard. *See Grogan v. Garner*, 498 U.S. 279, 283-91 (1991).

The debtor argues that the settlement that ultimately led to the second arbitration decision precludes the Court from looking at the circumstances that preceded the settlement to determine whether the debt is nondischargeable, and that the second arbitration decision established the total amount of the plaintiffs' claim against him. Finally, he contends that the plaintiffs' nondischargeability claim is barred by a Kansas statute of limitations. He is wrong on all three points.

The debtor's argument that the parties' settlement precludes the plaintiffs' dischargeability action is essentially identical to the theory rejected by the Supreme Court in *Brown v. Felsen*, 442 U.S. 127,

127-28 (1979), a decision under the Bankruptcy Act of 1898. In *Brown*, the debtor had been sued in state court by, among others, a guarantor who claimed his guarantee had been obtained through misrepresentations and nondisclosures of material facts. 442 U.S. at 128. When the parties settled, the guarantor received a judgment against the debtor but the basis of the debtor's liability was not stated in the settlement or judgment. *Id.* When the debtor later filed for bankruptcy, he claimed the guarantor could not then contest the dischargeability of the judgment, having had the opportunity to litigate that question in the state court suit. *Id.* at 128-29. Reversing the lower courts, the Supreme Court concluded res judicata (now more often called "claim preclusion") should not preclude the guarantor from litigating the dischargeability issue in the bankruptcy court. *Id.* at 132-39.

Although *Brown* was decided under the Bankruptcy Act of 1898, the Court believes its reasoning still controls. When the parties settled their state court lawsuit, the debtor's "bankruptcy [was] still hypothetical" and the Supreme Court refused to require creditors like the plaintiffs to pursue potential dischargeability issues "to protect [themselves] against the mere possibility that [the debtor] might take bankruptcy in the future." *Id.* at 135. Claim preclusion does not bar the plaintiffs from litigating dischargeability now.

While the Court agrees with the debtor that either claim preclusion (res judicata) or issue preclusion (collateral estoppel) bars the plaintiffs from asserting that the debtor owes them more money for the work that remained to be done on the house than the amount determined in the binding arbitration decision, the decision makes clear that it did not resolve all the plaintiffs' damage claims. Instead, the arbitrator said that someone else would have to determine the damages caused by the "defects that can't be repaired." The plaintiffs would be barred from pursuing such damages now if the

arbitrator had decided that they were not entitled to any, but he did not do that. Instead, he indicated the non-repairable defects had damaged the plaintiffs, and simply declined to decide the amount of that damage. Such a conclusion does not bar the plaintiffs from seeking a determination of those damages in this proceeding.

The debtor also suggests that the two year Kansas statute of limitations for fraud claims bars the plaintiffs' claim in this proceeding. However, the question in this case is not whether the plaintiffs can prove that the debtor owes them a debt for fraud, but whether the debt that he does owe them should be excepted from discharge because it resulted from fraud. The arbitrator's decision determined that the debtor owed the plaintiffs a debt, apparently based on breach of contract, for the cost of completing construction of the house plus an unspecified amount as damages for defects that could not be repaired. Now that the debtor has filed for bankruptcy, the plaintiffs are entitled to try to prove that the debt was incurred through fraud as well as breach of contract. The statute of limitations on fraud claims would be relevant only if there had been no previous determination that the debtor owed the plaintiffs a debt and they had no basis for a claim against him except for fraud.

For these reasons, the debtor's motion for summary judgment must be denied.

IT IS SO ORDERED.

Dated at Topeka, Kansas, this _____ day of February, 2002.

JAMES A. PUSATERI
CHIEF BANKRUPTCY JUDGE